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C O N F I D E N T I A L SECTION 01 OF 04 MANAGUA 001771

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TAGS: ECON EFIN ENRG EPET PGOV PREL NU
SUBJECT: NICARAGUA AND THE IMF HAVE A PRGF AGREEMENT

REF: A. MANAGUA 1672

¶B. MANAGUA 1180
¶C. MANAGUA 639
¶D. MANAGUA 640

Classified By: Ambassador Paul Trivelli, for reasons 1.4 b&d.

¶1. (C) Summary: The IMF and GON have almost completed a three-year Poverty Reduction Growth Facility (PRGF) agreement. After finalization of some budgetary numbers, the PRGF will go before the IMF Board in October. Characterizing the agreement as "plain vanilla," IMF ResRep Humberto Arbulu Neira stated it has no special or unusual components. The fiscal targets all follow the patterns established by the last PRGF (concluded December 2006.) The main structural issues include energy, capital spending controls, tax administration, pensions, and decentralization. The major hurdle throughout the negotiation, accounting for Venezuelan assistance and debt, may have become a non-issue when the ALBA oil deal was revised as a simple commercial credit program. Given the lack of any other coherent economic program from the Sandinistas, donors considered the agreement essential for releasing more funds to Nicaragua. Whether this program is completed will depend on the GON economic team's ability to balance the PRGF terms with Ortega's rhetoric of "battling global capitalism, led by the Yankee imperialists." End Summary.

The Agreement

¶2. (SBU) On July 9, after two weeks of intensive negotiations, the IMF and GON had almost completed a three-year Poverty Reduction Growth Facility (PRGF) agreement. A short meeting in DC the week of July 23 will finalize budgetary numbers and the PRGF will go before the IMF Board in October. Characterizing the agreement as "plain vanilla," IMF ResRep Humberto Arbulu Neira stated it has no special or unusual components. The PRGF contains specific targets for 2007 and projected targets for 2008 and 2009. Actual targets will be negotiated at the beginning of each year. The IMF will review Nicaraguan progress every six months. Stemming from this agreement, Nicaragua will receive between USD 80-90 million in disbursements over three years (an equivalent of 45% of Nicaragua's quota in the IMF.)

The Macroeconomic Indicators

¶3. (SBU) The major macroeconomic targets include:

	2007	2008	2009
-- Real GDP Growth	4.2%	4.5%	5%
-- Inflation	7.5%	7%	7%
-- Deficit (as % of GDP)	1%	1.8%	1%
-- Increase in reserves (USD)	60M	70M	80M
-- Exchange rate (crawling peg)	5%	5%	5%

(Note: Nicaraguan GDP for 2007 will be about USD 5 billion. End note.)

¶4. (C) Arbulu believes the targets for GDP growth and inflation for 2007 will not be met. He feels the 4.2% growth rate is optimistic given the flat growth rate of 3% measured by the Major Economic Activity Index (IMAE), the slow GON capital spending, and the continuing lack of an economic plan by the Sandinista government. Since the June accumulated annual inflation was 6% due to high oil prices, inflation for 2007 will be closer to 9%. Arbulu believes the deficit target will be easily reached, given that tax revenues are already higher than budgeted. Contrary to local press reports, IMF-GON differences over net international reserves were easily resolved, according to Arbulu. The IMF convinced the GON to tie reserves to imports and not the M2 monetary base. (Note: Nicaragua has already met its 2007 reserve target. End note.) Both sides agreed that, even with the increases, reserve rates are not high enough to support Nicaragua abandoning its crawling peg exchange rate for a free float.

¶5. (SBU) Differing from past years, the IMF required the GON to include the full costs and funding sources for its poverty reduction programs. Given President Ortega's habit of announcing large-scale social programs with no clear source of financing, the IMF felt it was prudent to commit the GON to clear numbers for its eight major poverty reduction programs (all based on Millennium Development Goals- MDG). Usually, financing sources for such programs are the purview of the government, not the IMF.

Social Indicators

¶6. (SBU) The GON will include social indicators in its Memorandum of Intent. Originally, the GON's wanted these indicators to replace the PRGF's macroeconomic indicators as targets. According to Central Bank (BCN) General Manager Jose de Jesus Rojas, the GON will publish yearly results/advances for their chosen targets. Matching MDG goals, the major indicators will be:

	2007	2008	2009
-- Primary education reg.	85.1%	87.6%	90.1%
-- Illiteracy rate	18.5%	14%	10%
-- Maternal mortality (Per 100,000 live births)	96	94	90
-- Access to potable water (% of total population)	65%	70%	78%

The Structural Agenda

¶7. (SBU) The main structural issues in the PRGF include energy, capital spending control, tax administration, pensions, and decentralization. None of the structural targets from the previous PRGF were carried over (pension reform, energy regulation reform, etc.) The primary focus of the energy target will be the high loss level in the system (almost 30%), caused principally by theft. Commitments include a law penalizing electricity theft and fraud, an audit of the electrical system to determine sources of technical losses, and a plan to increase coverage in poor and rural areas, thereby reducing theft and improving service. (Note: This program is modeled on a successful Colombian program and will receive IDB technical assistance. End note.) As part of these commitments, the GON will revisit the current 100% subsidy for users of less than 150KW per month (about 60% of users.) The GON also agreed to publish the

formula for calculating the automatic tariff increases, and will announce the scheduled increases throughout this year, increasing transparency in the system. (Note: The National Assembly has frozen electricity tariffs for one year. The GON has committed to raising tariffs to the scheduled level when the freeze ends in the summer of 2008. End note)

¶8. (C) The IMF was particularly concerned over the low levels of capital spending by the Sandinista government and dedicated a significant portion of the last round of negotiations to the issue, according to BCN GM Rojas. The GON requested that the PRGF allow them to take advantage of the increased inflows of concessional rate funds for infrastructure projects in energy and water. The PRGF objective is to increase capital expenditures from 5.1% of GDP to 7.4% (from USD 225 million to 370 million). The PRGF allows the GON to create a state-owned development bank (Banco de Fomento) which could become involved in some of these capital projects. Both Rojas and Arbulu expressed concern about the GON's ability to meet these markers and the economy's capacity to absorb these funds. They also believe that the increased spending may not result in quality projects. Complicating the issue, according to Arbulu, Nicaraguan capital accounts are heavy on salaries as a result of a transfer from the current account to meet the last PRGF's savings target. The IMF has promised technical assistance to help the GON figure out how to reverse this action.

¶9. (SBU) The PRGF, endorsing current improvements in tax policy and administration, focuses on improving the accounting and budgeting process for state revenues. For the last three years, as a result of technical assistance programs such as U.S. Treasury's OTA program, the General Office of Taxes (DGI) has collected 0.5% of GDP more than allotted in the budget (in 2007 it will be 0.6% - USD 30 million.) The PRGF requires the GON prioritize projects so additional funding will be assigned according to state needs. Clear guidelines for programming and spending are a key component of this section of the PRGF.

¶10. (SBU) Decentralization will be on the back burner until 2009 as the GON refused to contemplate changes to the system until after the November 2008 municipal elections. Currently, the municipalities receive 6% of the budget (increasing 1% a year for the next four years). In exchange the municipalities are expected to administer local schools, water, health, and social security services. So far, the municipalities receive the money but have not taken on the additional responsibilities, claiming they need new infrastructure to do so. As a result the central government provides these social services from its own budget and the mayors do not have to account for how they spend their 6%. The PRGF contemplates a 2008 law mandating the municipalities take on the social services in exchange for their 6%. In 2007 and 2008, the GON must cut spending in other parts of the budget to offset the mandated 1% increase to municipalities.

¶11. (SBU) Due to the large divergence between IMF and GON estimates on the viability of Nicaragua's pension system (INSS), both sides agreed to step back from pension reform at this time. Instead the PRGF calls for a new actuarial analysis of INSS, so that future discussions center on the same numbers. The PRGF also requires a phase out of a law, currently on legislative hold, which increases INSS benefits. These additional benefits, both sides agreed, would bankrupt INSS in five years.

Where is the Venezuelan Assistance?

¶12. (C) The major hurdle throughout the negotiation has been accounting for Venezuelan assistance. The IMF was particularly concerned with the potential revenues and debt accumulated through the Bolivarian Alternative for the Americas (ALBA) oil deal (reftels). Ortega has been consistence in his calls to keep the assistance off-budget

and out of the public spending accounting system. (Note: In response to GON statements during the negotiations that MCC assistance is off-budget, the IMF responded that they would be pleased to have the Venezuelan assistance contain all of the transparency and public spending reporting requirements contained in the MCC-GON agreement. End note.)

¶13. (C) According to Arbulu, even though the PRGF now requires three operational and financial reports a year from Petronic, the oil debt with Venezuela may become a non-issue as the deal has been completely revamped, again. (Note: This would be the fourth iteration of the deal since the original signing on January 11. End note.) The GON told the IMF that the deal had been converted to a straight commercial credit program, with no long-term debt accrual. According to Arbulu, Venezuela will sell petroleum products (not crude) to Nicaragua (through state oil company Petronic) at market rates, and provide a 90-day market credit. These new terms are to be singed during the upcoming ALBA meeting in Cuba. The IMF is requiring a finalized agreement before the PRGF can go to the IMF Board.

¶14. (C) The GON also informed the IMF that during the Havana meeting they will sign the charter creating the ALBA Fund Bank, which will finance projects in all its member countries. Details on the Bank, how it will be funded (from some of the money from the oil payments?) and how this money will be distributed to the different ALBA countries, are not clear at this time. According to Arbulu, the GON confirmed that funds from the ALBA Bank will follow all of the standard transparency regulations and any loans will be approved by the National Assembly, per Nicaraguan budgetary administration laws. The amount of funds involved, and the ability of the Nicaraguan economy to absorb then, is an issue the IMF will continue to explore as the PRGF progresses. Currently, the PRGF allows for Venezuelan assistance amounts equivalent to around 2% of GDP (about USD 100 million) to be used for infrastructure projects. (Note: Some sources indicate that this may actually be an allowance for the deficit to go up to 2% of GDP in order to finance the Nicaraguan portion of the new Venezuelan refinery. End note.)

¶15. (C) BCN President and lead GON negotiator Antenor Rosales has evaded press questions on accounting for Venezuelan assistance by saying that the issue was clarified in past negotiation sessions; adding that "the IMF did not succeed in getting Petronic to be part of the National Budget." He has not publicly revealed the changes in the terms of the oil deal, claiming instead that the assistance is a non-issue because existing laws provide for transparency on the funds.

Comment

¶16. (C) While it is true that this is a bare-bones PRGF, it provides much needed assurances for macroeconomic stability. Given the lack of any other coherent economic program from the Sandinistas, donors have long considered the agreement essential for providing the assurances necessary to release additional funds to Nicaragua. This release of funds is important for the GON economic team, according to Arbulu, because they have realized that Venezuela is not the cash cow Chavez had painted it to be. Whether this program is completed will depend on the GON economic team's ability to balance the PRGF terms with Ortega's rhetoric of "battling global capitalism, led by the Yankee imperialists." End Comment.
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